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INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC PRIORITY
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C O N F I D E N T I A L SECTION 01 OF 03 WARSAW 000288

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E.O. 12958: DECL: 03/16/2012
TAGS: EFIN ECON PL
SUBJECT: POLISH FINANCIAL SECTOR: WILL THEY NEED THE IMF?

REF: A. 08 WARSAW 1217
¶B. WARSAW 191
¶C. WARSAW 253

Classified By: EconCouns M. Sessums for reasons 1.4 (C,D).

¶1. (C) Summary. Poland's financial sector continues to look sound, with adequate liquidity and access to global markets. However, potentially serious vulnerabilities have been exposed by the prolonged strain on European parent banks, the deepening economic downturn, and the steep decline in the currency (recently rebounding). One longtime Embassy contact and unofficial economic advisor of PM Tusk has become more worried about the potential fallout of the global economic crisis in Poland and is trying to identify possible triggers for a Polish crisis. He has reached out to tell us that he is talking, quietly and informally, with the IMF regarding potential assistance in financing Poland's budget deficit, anticipated to grow beyond four percent of GDP. He did not predict or suggest an official GoP approach to the IMF; rather he billed his outreach as an effort to make sure Washington would not be caught off guard should Poland suddenly request help. End Summary.

Quiet, Precautionary Talks with IMF

¶2. (C) Polish economists, financial sector analysts, regulators, and government officials generally remain positive that Poland will suffer but survive the crisis thanks to sound financial sector fundamentals and a history of cautious regulation (REF C). Influential conservative economist, Leszek Balcerowicz, insists he has already moved beyond the crisis, and is more concerned with over-reaction and overzealous market regulation than any impending financial collapse. He and his proteges, who dominate the local economic community, see Poland emerging from the crisis in a strengthened position thanks to their prudent supervision and a more competitive exchange rate.

¶3. (C) Balcerowicz's former colleague and current informal advisor to PM Tusk, Ryszard Petru, admits the GoP has been overly optimistic. In a March 13 discussion with the Ambassador and EconOff, Petru said he had been in contact with the IMF earlier that week seeking assurances that Poland could access up to USD 10 billion in IMF support, if needed. Importantly, Petru has no formal government position. His discreet talks with former Polish Prime Minister and current IMF Director Marek Belka were structured to avoid drawing unwanted attention to Poland as it struggles to differentiate itself from its more troubled neighbors. Petru told us he has no sense that any one area will trigger larger problems, but together the following vulnerabilities could ultimately

lead to the need for IMF assistance.

Will Banks Continue to Lend?

¶4. (SBU) The biggest question-mark for the Polish financial sector remains: how will European-based parents instruct their local subsidiaries (70% of the Polish market)? Polish banks had record profits in 2008. Although 2009 profitability may suffer thanks to slowing Polish growth and the potential for increasing unemployment to drive up credit defaults, banks cautiously continue to lend. The Central Bank estimates that credit growth to the private sector, while slow, increased by about 1.3% in the first two months of 2009. Nevertheless, interbank lending still almost entirely relies on Central Bank guarantees (the parent banks do not trust each other). An instruction from parents banks in Rome, Frankfurt, or elsewhere to their local subsidiaries to stop lending and wait out the crisis could have disastrous ripple effects in the Polish financial sector (REF A). Ministry of Finance and Central Bank officials tell EconOffs they are considering, as a contingency, a plan to capitalize one or both state-owned banks and instruct them to expedite lending in the case of temporary market illiquidity.

Exposure to a Weakened Currency

¶5. (SBU) FX Derivatives: The zloty (PLN) has hit 5-year lows against the dollar and the euro over the past two months. This follows a four-year run of more or less consistent appreciation until summer 2008. Some Polish companies and

investors bet on continued zloty strength. Polish financial supervisors recently estimated potential losses related to currency derivatives at about PLN 16 billion (USD 4.6 billion). Of that amount, approximately PLN 1.3 billion (USD 375 million) is estimated as uncovered exposure held by the Polish system. The remainder represents genuine hedges by companies with trade-related currency gains to match their FX losses (usually exporters) or contracts where a corporation's zloty exposure is matched by a domestic bank holding the other side of the contract (euro exposure). These estimates would increase with a further drop in the currency (which has actually appreciated in recent weeks), but potential derivative-related losses alone are not seen by regulators as sufficiently large or widespread to shake an otherwise healthy financial system.

¶6. (SBU) Mortgages: Similarly, Poland's mortgage market is dominated by Swiss Frank (CHF) mortgages; over 60 percent of outstanding value. However, mortgages are a new phenomenon in wealthier, urban areas and limited to the equivalent of about 15% of GDP. The immediate liquidity problems of banks financing these mortgages were ameliorated thanks to a Central Bank FX swap arrangement. The swaps allowed banks to continue their short-term servicing of the mortgages (NOTE: Polish banks borrowed CHF and issued clients with zloty mortgages keyed to CHF rates using short-term financing arrangements to manage their CHF debt). Whether or not this leads to defaults will in large part depend on how long and how far the zloty depreciates or how quickly it recovers. Household ability to finance increased mortgage costs will also depend on the extent of the downturn here and its impact on employment and wages.

Crowding Out: Will the GoP be able to Access Funds?
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¶7. (C) Poland's corporate sector financing is largely short-term. The government has also relied on short-term debt in recent years, and has about PLN 160 billion (USD 46 billion) in domestic financing requirements for 2009 (much of this coming in Q2-Q3). The GoP still has access to credit markets; however, recent bonds were sold at over 400 bp above

US Treasury rates. GoP officials worry that huge global stimulus efforts could put the cost of borrowing out of reach if a new bond issuance coincides with renewed currency weakness and some unforeseen shock from the region.

¶8. (C) In the absence of a deeper European collapse, officials privately expect the 2009 deficit will grow to about 4% of GDP. This does not include off-the-books debt such as World Bank program loans (they have expedited borrowing), government guarantees for state-owned company bonds, and bond-issuing entities such as the planned road fund. While most of this creative accounting falls within EU norms, a straightforward approach would probably add another percentage point or more of GDP to the deficit. Renewed weakness of the currency would add to their otherwise manageable FX financing requirements. Earlier in the crisis, GoP analyses estimated that they could continue to finance so long as the zloty remained below a euro/PLN rate of 4.3/1 (it is currently about 4.5). Asked why the government didn't expedite bond issuances in anticipation of these problems, Petru admitted they were too optimistic and Minister of Finance Rostowski simply underestimated the potential for crisis in Poland. The desire to send positive signals outweighed the urgency of preparing.

Comment: Little Things Might Add Up

¶9. (C) Poland has grown impressively in recent years (over 5%) without building up large financial imbalances that have made many of its neighbors more vulnerable to the global financial crisis (REF C). Alone, the economy could easily absorb the losses of some bad currency bets. A correction of the zloty should help exports and even attract FDI away from higher-cost Europe (REF B). However, Poland is facing a sustained recession in its Western trading, finance and investment partners, combined with a deeper crisis in the region. If Poland's short-term financing requirements coincide with another negative market surprise or renewed investor concern with CEE-wide risk, it temporarily may not be able to finance government spending. We believe that the point of Petru's outreach is not to predict an IMF bailout. Rather, he is seeking to prepare Washington decision-makers

for the possibility of a Polish approach to the IMF and to explain why an otherwise healthy Poland may need to join the ranks of CEE countries turning to the IMF for help.
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